Reform of the global financial architecture: a new social contract between society and finance

Hugo BANZIGER
Chief Risk Officer and Member of the Management Board
Deutsche Bank

The current global crisis poses significant challenges for our financial system, our economies, and our societies. Overcoming these will require a new "social contract" between society and finance. This must include improvements to corporate governance, a reform of capital requirements, a more transparent and less procyclical accounting framework, banking laws to reflect modern financial markets, better infrastructure, and stronger supervision. Given the global nature of today's capital markets, it will also require efforts to be coordinated, if not harmonised, internationally in order to avoid any re-fragmentation and re-nationalisation of the financial system. Addressing these challenges is essential to creating a financial framework that can support prosperous growth in the coming decades.

1| Learning from the past

It is exactly 75 years ago that a new US administration enacted sweeping regulatory changes to America's financial markets. When US President Franklin Delano Roosevelt said in his inauguration speech, that there is "nothing to fear but fear itself", he set not only the tone for his first year in office but also marked the turning point of the economic and financial crisis at the time.

Roosevelt had understood that a return of economic, financial and political stability would require co-ordinated action on several fronts: first, a stabilisation of the banking system, the basis for which was laid by the Emergency Banking Act. The Act allowed for the closure of insolvent banks and the re-opening of sound banks after a thorough assessment of their health. Second, the Federal Reserve reversed its monetary policy course and began to expand the monetary base. Third, upon request of the Roosevelt administration, the US Congress embarked on a programme of fiscal expansion. Fourth, and most crucially, the Roosevelt administration recognised that all of the afore-mentioned measures would be futile if trust in the financial system was not restored. And as the private financial sector had lost the necessary credibility to establish this trust by itself, there was no alternative but to take political action.

Efforts to restore trust had, in fact, already started in the previous year with the investigations into the causes of the 1929 stock market crash. The hearings, which unearthed evidence of wide-spread market abuse, paved the way for the 1933 Securities Act. Together with the 1934 Securities Exchange Act, which created the Securities and Exchange Commission (SEC), it restored market confidence by providing investors and the stock exchanges with more reliable information and clear rules for transparent and fair dealing in securities. Similarly, the Banking Act of June 1933, co-authored by Sen. Glass and Rep. Steagall, not only enshrined the separation of commercial and investment banking, but also created the Federal Deposit Insurance Corporation (FDIC) in an effort to bolster depositors' trust in the banking system. The institutional structure of supervision, too, was changed, when the Federal Reserve assumed supervisory powers for the first time. Thus, in essence, the Banking Act was the institutional reinforcement of the measures Roosevelt had taken immediately upon assuming office in March 1933. In fact, the institutional legacy of the actions taken by the first Roosevelt administration shaped US financial markets for decades and provided the foundation for solid growth after the Second World War.

2| Restoring trust and reviving private capital flows

Why this excursion into economic history? Essentially, because it provides an insight into the fundamental importance of trust as the basis for any effort to restore the stability of the financial system and financial institutions. Stabilising banks, easing monetary policy and the use of public money are all necessary elements for overcoming a systemic banking crisis. But necessary though they are, they alone are not sufficient. Roosevelt's reformist agenda in essence created a new "social contract" between society and bankers. Banks as private institutions were allowed to manage citizens' money and wealth provided they agreed to oversight and supervision by the government. This new "social contract" established the trust necessary for deposits to return to banks and investors to buy shares again.

Today, our challenge is not that different. A brief glimpse at the scope of the problem illustrates why: If, as some fear, losses for the financial system from the current crisis will, in the end, really amount to up to USD 4 trillion, this would clearly overwhelm the ability of public budgets to recapitalise the banking system. Put differently, in order to stabilise the financial system, a sufficient level of trust must be restored that allows for a return of private capital into the financial system. Only when the holders of the more than USD 100 trillion of financial assets worldwide are willing again to put their funds at risk (rather than keeping it in cash and government securities) will financial flows normalise and stability return.

It is this philosophy that, in my view, is the underlying rationale of the latest US plans to deal with illiquid, hard-to-value assets on the balance sheets of US banks. As the purchase of these assets by the state alone is not feasible, it is sensible to leverage public funds with private capital to deal with the problem.

However, drawing lessons from the Great Depression does not mean that we should copy blindly the legislation of the 1930s. In my view, it would be a mistake to replicate the separation of commercial and investment banking – notwithstanding the fact that some observers currently (like Nobel Prize winner Edmund Phelps) suggest doing so. Indeed, stand-alone investment banks were actually the first victims of this crisis. Investment banks *per se* were not the cause of the current financial turmoil. The world needs their capacity for underwriting debt and equity products and market-making/trading of financial instruments. The crisis was caused by large proprietary positions, regulatory arbitrage, considerable funding mismatches and a complete failure of corporate governance in several banks.

Consequently, calls for a return to a split banking system or for the introduction of a "narrow" banking system are misplaced. These concepts would create significant welfare losses without addressing the underlying causes of the crisis. Similarly, turning the banking industry into a utility – tightly regulated and subject to stringent product and pricing caps – would entail a re-nationalisation of banking markets, obliterating decades of work in efficiency and market integration. Thus, in our quest for more stable and resilient structures for global financial markets, we need not only to find solutions that are appropriate to the realities of our times, but also reinstate the "social contract" that was broken by the financial industry in the last two years.

3| Efforts to redesign the regulatory system can build on sound basis

Fortunately, there is no lack of blueprints for reforming the international financial system. A number of reports have been issued by public sector bodies over recent months[1], which provide a wide range of measures considered appropriate to forestall a recurrence of such problems in the future. The private sector welcomes and essentially supports the recommendations set out in these reports. They are appropriate measures to re-establish trust and functioning markets. Simultaneously, the private sector has also presented a great number of proposals.[2]

It is noteworthy and, indeed, very welcome that there is a large overlap between all these reports and a broad agreement between the official and the private sector on the areas in need of change. All reports identify the need for reforms in the areas of risk and liquidity management, transparency, market infrastructure, capital requirements and remuneration practices. This not only reflects a broad consensus on the causes of the crisis, but also represents the fruits of efforts made in recent years at intensifying the dialogue between the private sector and regulators. From this dialogue, a broad agreement has developed on a regulatory philosophy based on the central tenets of principles-based and risk-based supervision.

4| Banks' corporate governance and risk management needs upgrading

Appropriately, banks' internal governance structures and risk management are at the heart of the recommendations listed in the afore-mentioned reports. The crisis revealed the need for clear improvements in these areas, such as risk management independence in all parts of the bank and increased responsibilities for Management Boards. Boards need to decide on the risk appetite, which should be based on the firm's loss tolerance, and need to be involved in the continuous monitoring of risk positions. This implies a more rigorous selection process for Senior Managers and the need for them to have frequent and transparent information on the firm's risk positions.

1 *The most important documents have been the Action Plan issued by the Financial Stability Forum (April 2008), the G20 communiqué (November 2008), the Larosière report (March 2009), and the Turner report (April 2009).*

2 *Amongst them the report of the IIF's Committee on Market Best Practices (July 2008), the third report of the Counterparty Risk Management Policy Group (August 2008), and the Group of Thirty report (January 2009).*

This, in turn, is only achievable if banks have robust information technology (IT) systems in place that allow for real-time and group-wide aggregation of risk positions. At Deutsche Bank for instance, the IT infrastructure that we have built up in recent years — including a 'golden source' for all risk positions and parameters — proved to be invaluable during this crisis, as it enabled us to continuously aggregate, report and manage our positions. The industry as a whole needs much better IT systems, which have to include global firm-wide data warehouses in order to capture all risks. Data accuracy and completeness should be audited, and all risk models and stress tests regularly back-tested. Banks also need to invest in their stress testing systems: stress tests need to be systematic and standardised and must integrate all tests as is already being done in Economic Capital calculations.

The need for continuous and improved stress testing equally applies to liquidity management, where it turned out that the stress scenarios used were not extreme enough. While better stress tests address one of the severe deficiencies in many banks' liquidity management, the crisis also demonstrated the need for strategic liquidity reserves. Such reserves should cover on- as well as off-balance sheet funding needs for at least two months. As an example, since the start of the crisis Deutsche Bank has put significant effort into systematically building up a strategic liquidity reserve. At year-end 2008, this reserve amounted to more than EUR 57 billion, which, by and large, covers all short-term liabilities.

However, improving governance and risk management is not only a function of technical infrastructure and improved processes. Sound risk management can only be achieved with experienced and well-trained staff — which is, in my view, another important lesson to be learned from this crisis. Apart from a deep understanding of the risks employees take and manage, they have to be familiar with accounting and regulatory rules as well. Consequently, mandatory training programs for every risk officer should be considered. At Deutsche Bank, we have addressed this, among other initiatives, by a comprehensive training program including mandatory accounting seminars for risk managers. Enabling easy career transfers between front and back office is a further crucial element. It should go hand-in-hand with a harmonisation of compensation levels between front and back office.

A lot has already been said and written about the need to reform the financial industry's compensation policies. As outlined in the recently published Institute of International Finance (IIF) Principles, compensation should be performance oriented, aligned with shareholders' interests, long-term in nature, risk-adjusted with claw-back features, and transparent to all stakeholders in order to avoid excessive risk taking.

Thought should also be given to how the current proposals and enhancements will be implemented in financial institutions and how this will be monitored going forward. A potential solution could be that International Capital Adequacy Assessment Process (ICAAP) formally certifies all risk management processes. Given the banks' importance for the economy as a whole, such certifications would be justified in the same way our societies request the certification of the safety of drugs, food and nuclear power plants, etc.

5| REFORMING CAPITAL REQUIREMENTS

Apart from risk management, capital levels in the banking industry form an essential part of the debate. The crisis revealed that the capital levels held by many banks were not commensurate with the level of risk. There is a clear message that banks individually, and the financial system as a whole, need to hold more and better quality capital. Banks should also ensure they have a large cushion of contingent capital reserves that can be converted during a downturn.[3]

Also, modifications must be made to the capital adequacy framework for Market Risk. At Deutsche Bank, we hold for Market Risks around 4-5x more Economic Capital than regulatory capital. Whilst insufficient capital levels are punitive during a crisis, they are even worse during good times since they allow the build up of oversized risk positions. The proposals of the Basel Committee for Banking

3 *Contingent capital = senior bank debt with a conversion option to sub-debt.*

Supervision to substantially increase capital levels for sales and trading are thus a logical step in the right direction. They will also prevent capital arbitrage between the trading and banking books as these proposals will entail higher capital requirements for securitisations and for credit risk in trading books. In my view, these are appropriate adjustments.

In recent months, increased attention has been paid to the concept of a minimum leverage ratio. While a simple leverage ratio represents only a very crude instrument to measure risks, it would nevertheless lead banks to put increased focus on (the growth of) their balance sheets. Had such a minimum requirement been in place before the crisis started, the failures of banks whose sheer balance sheet size contributed to their collapse might have been avoided.

6| ADDRESSING PROCYCLICALITY

Given the inherent cyclical nature of financial markets, there is a fundamental conceptual issue that needs to be solved: how to address the issue of procyclicality that is a logical concomitant of any risk-sensitive capital framework. While risk sensitivity is an appropriate tool to control risk at the level of the individual firm, if not properly designed it creates undesirable systemic implications when all institutions covered by such rules simultaneously aim to raise capital, reduce their risk-weighted assets (RWA) and exit from trading positions.

There are four significant procyclical elements in today's regulatory framework:

- value-at-risk (VaR) based capital requirements for market risks;

- credit rating based capital requirements for credit risks (Basel II);

- fair value accounting of illiquid products under both US Generally Accepted Accounting Principles (GAAP) and International Financial Reporting Standards (IFRS);

- procyclical reserve requirements under both US GAAP and IFRS.

The interaction of these four components contributed significantly to the downward asset price spiral that we have experienced since the outbreak of the crisis. Although the correction of these deficiencies will require a lot more detailed work, conceptually these issues are relatively easy to address.

6|1 VaR based market risk capital requirements

Instead of taking the average of the last ~250 trading days, which makes VaR volatile and understates the risk after long periods of benign markets, VaR could be calibrated using the most extreme price movements over, let's say, the last twenty years.

6|2 Credit rating based capital requirements

Equally, instead of calibrating the Basel II credit risk charge by using averaged credit data of the last five years, it could be calibrated by taking the default and recovery rates from the last three recessions.

6|3 Fair value accounting of illiquid products

If the accounting treatment for holding asset were based on "capacity to hold" rather than "intention to hold", investment portfolios could no longer be held in the trading books and would have to be financed to final maturity. This would not only address the maturity mismatches but also alleviate the pressure to sell when short-term financing is no longer available.

6|4 Procyclical reserve requirements

The current reserve requirements, which are based on observable events, could be replaced by dynamic provisioning which is based on expected events in the future; such dynamic reserves should also be tax-deductible.

At this point in time, only stress-based VaR and dynamic credit provisioning are under discussion by regulators and supervisors. Much more work still needs to be done to address all procyclical factors in our accounting and regulatory regime. It is understood that instruments such as dynamic provisioning would have to be accompanied by stringent disclosure requirements in order to prevent their misuse for manipulating financial statements. Last but not least, even if all the above issues are addressed simultaneously, the financial system will remain cyclical. To dampen the cycles, a more stability-focused monetary policy is required to mitigate financial imbalances and asset bubbles.

7| ESTABLISHING MACROPRUDENTIAL SUPERVISION

Addressing procyclicality in the design of regulatory and risk management systems requires methodical and comprehensive monitoring of systemic risk. In recent years, financial supervision has primarily focused on microprudential supervision, looking at the health of individual financial institutions, but has neglected the aspect of macroprudential supervision, i.e. the monitoring of the health of the financial system as a whole and the identification of threats to financial stability.

Last but not least, the threats to global financial stability that were bound to result from the build-up of severe macroeconomic financial imbalances were noticed and widely commented upon, but did not lead to any concrete policy action aimed at reducing these imbalances.

There is now a broad consensus that macroprudential supervision must assume a more prominent role in the set-up of financial supervisory regimes. In fact, in both the United States and the European Union, proposals have been put forward for establishing "systemic risk supervisors". In the United States, it is widely suggested that the Federal Reserve System (Fed) assumes this role. In the European Union, the Larosière report proposes the establishment of a European Stability Risk Council (ESRC) under the auspices of the European Central Bank (ECB).

The current crisis has revealed that in a globally integrated market, financial instability is quickly transmitted from one market to another. There is therefore a need for supplementing the new macroprudential supervisory structures in the United States and the European Union with appropriate structures for coordination at the global level. The Financial Stability Board is the natural location for this.

8| FINE-TUNING MICROPRUDENTIAL SUPERVISION

While there is a need to establish macroprudential supervision, it will only be effective if it is translated into concrete action at the political and microprudential level.

First, supervision needs to be comprehensive and extended to all market participants and infrastructures. Market participants not regulated in the past, such as asset-backed commercial paper funds, structured investment vehicles, money market funds, hedge funds, private equity, mortgage originators and financing companies must be brought into the regulated system.

Second, supervision must be risk-weighted. It must follow a risk-based approach where scarce supervisory resources are directed to the greatest risks. This would mean that large, important financial institutions — such as Deutsche Bank — need to be more intensively supervised than smaller market participants. We welcome this intensified supervision as it is in our genuine self-interest that other systemically relevant participants are supervised appropriately.

At the other end of the spectrum, hedge funds, which – contrary to perception – have not caused this crisis, could be regulated lightly. The Financial Services Authority (FSA)'s approach to require the registration of hedge fund managers, to subject funds to information requirements and intensive monitoring of their ties with prime brokers, is a very reasonable one and has rightly been commended by the Larosière report.

Third, effective microprudential supervision is only feasible if regulators are given the right set of enforcement tools. These tools should be reasonably differentiated and incentivise financial institutions to automatically comply with rules and regulations. For example, the voluntary correction of self-identified and self-notified breaches should be rewarded, while breaches that are not notified should be penalised. With such a set of enforcement tools, banks would build a self-policing culture, which would be more efficient than just a system of checks and controls.

Fourth, prudent supervision on a micro level also requires a coordinated approach and an improved exchange of information between supervisors (colleges). Here again, the Larosière report points in the right direction with the proposal of a European System of Financial Supervision (ESFS).

9| Strengthening market infrastructure

A further element to bolster the resilience of the global financial systems is the strengthening of market infrastructure. This is not just an issue of greater efficiency; rather, it is one of financial stability. The financial infrastructure for settling and clearing of payments, securities and derivatives must be able to act as a shock absorber. It must allow the system to withstand the failure of major market participants. Unfortunately, however, most of our market infrastructure dates back to the times of nationally fragmented markets and to the days of unsophisticated, low volume markets. Clearly, such structures are no longer adequate.

Fortunately, we are not starting from scratch here. Major progress along these lines has already been achieved as regards the clearing of credit default swap (CDS) contracts. This goes back to an initiative by the New York Fed, but the implementation has been a private sector effort, with Deutsche Bank playing a leading role.

Comparable efforts would be sensible in other market segments, such as FX trading and payment services. Indeed it can be argued that such key market infrastructures should be structured in a way that insulates them from the potential troubles of any single market participant, especially those that are systemically important. To achieve this, system designs that rely on CCP-type[4] structures are useful. In addition, keeping the bankruptcy of network structures remote from market participants can serve a similar purpose. Incidentally, this does not mean that such infrastructures must be run as public utilities; but it does mean that they must be organised in a way that prevents a negative spill-over from other, unrelated market segments into vital, shared infrastructures of the financial system. In many societies, railway networks or power grids are already managed in a similar way.

Although often neglected, the need to improve financial market infrastructure extends beyond clearing, settlement and payment networks: the outbreak of the financial crisis revealed that the market infrastructure for the trading and pricing of complex financial instruments has not kept pace with market developments. Innovative structured products were introduced to the market, but many participants lacked the ability to price these correctly and to monitor the risk contained therein. This inability led them to rely on external judgements – specifically the opinion of rating agencies – rather than on their own judgement. This ignored the simple rule that ratings can only be a complement for one's own risk assessment, not a substitute.

The markets for these products will only revive if investors regain confidence in their investment decisions. Markets and their participants need reliable price signals and a robust pricing infrastructure. For this to happen, we need to have a pooling of information on transaction volumes and prices. We also need transparency on the underlying assets of structured products, so that investors and supervisors are able to perform their own risk assessment. Relevant information should be publicly available and regular updates should be mandatory. With today's internet, such information could be easily made available online.

In addition to better disclosure, higher standardisation is required. It will reduce complexity in structured

4 CCP = Central Counterparty

credit markets and would help to increase transparency and stability. Standardisation is also conducive to greater market liquidity, which, in turn, would make it more likely that market prices are available even in a difficult market environment. A comparison with the market for *Pfandbriefe* (covered bonds) may be instructive: overall, this market segment has fared better than securitisations due to the greater transparency, liquidity, uniformity of products and longer track-record that mark these products.

We are still in the middle of a global crisis that is generally accepted as being the most severe since the 1930s. It poses significant challenges for our financial system, our economies, and our societies.

To overcome this crisis, we need a new "social contract" between society and finance. This contract has to be simple and easy to understand, provide certainty to financial markets and safety for the money that our citizens put into financial institutions. It has to address the root causes of the current crisis and provide the basis for a fundamental reform of the way the industry does business.

Such a contract has to include far-reaching measures like: improving banks' corporate governance; making the accounting framework more transparent, consistent and less procyclical; adjusting the banking laws to the realities of modern financial markets; and strengthening supervision that is both effective and efficient. Ensuring we have a sound market infrastructure will also serve as a further shock absorber for our financial markets.

All these areas must be addressed simultaneously and we must thoroughly communicate our intention to put financial markets on a new footing for our citizens and market participants. Given the global nature of today's capital markets, these efforts have to be coordinated, if not harmonised, internationally in order to avoid any re-fragmentation and re-nationalisation of the financial system.

Just as the Roosevelt administration eventually succeeded more than seventy years ago, there is no doubt that this current generation is able to develop a new financial framework that will support prosperous growth for the decades to come.